AP Macroeconomics
Test: Money
Instructor's Version

Answers: Free-Response Questions

1. Money Demand

A. Describe the three uses of money. (3 points)

Answer:
1. Medium of exchange — used to trade
2. Unit of account — used to indicate or compare different values
3. Store of value — used to hold on to purchasing power

1 point for each — the answer must be complete to get credit.

B. List the traits of good money. (5 points)

Answer:
1. Easy to transport
2. Easy to verify
3. Easy to divide
4. Should keep well
5. Should be stable in value

1 point for each.

2. Federal Reserve

A. Name and describe the Fed's most commonly used tool of monetary policy. (2 points)

Answer: Open market operations is the Fed's most commonly used tool. This involves the Fed buying and selling Treasury bonds on a daily basis.

1 point for each sentence.

B. Describe the three different ways the Fed could "cool down" the U.S. economy. (6 points)

Answer:
1. Using open market operations, the Fed could sell more bonds than it buys to take money out of the economy and slow investment.
2. Using the discount rate, the Fed could increase the interest rate to reduce the incentive to borrow.
3. Using the required reserve ratio, the Fed could increase the percentage of deposits a bank is required to hold in reserve to cut down on loans.

2 points for each.

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C. Suppose that the Fed uses open market operations to buy more bonds than it sells. Describe the effects this will have on the U.S. economy. Be sure to explain why each effect takes place, referencing the *AD/AS* model when appropriate. (6 points)

Answer: By buying more bonds than it sells, the Fed puts more money into circulation. This increases the money supply. When the money supply increases, interest rates decrease. When interest rates decrease, borrowing and investment both increase. The resulting increase in production shifts the aggregate supply curve to the right. This leads to an increase in RGDP and a decrease in the price level.

1 point for each sentence.

3. Monetary and Fiscal Policy

A. Using Monetary Policy

I. Use a graph and a written explanation to describe the effect of a contractionary monetary policy. (3 points)

Answer:
Graph: A money supply graph with downward sloping demand curve and two vertical-line supply curves, with a left-facing arrow going from one supply curve to the other.

Explanation: When the money supply decreases, interest rates increase.

2 points for the graph (1 point for setting up the graph correctly, 1 point for showing the supply curves in the correct orientation); 1 point for the explanation.

II. Describe stagflation and explain why monetary policy is ineffective when an economy faces stagflation. (3 points)

Answer: Stagflation results from a supply shock that both decreases aggregate supply and lowers RGDP, while increasing the price level (stagnation (increased unemployment) and inflation). The use of an expansionary monetary policy to increase RGDP will make inflation worse. Using a contractionary monetary policy to combat inflation will make RGDP decrease even more.

1 point for each sentence.

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B. Economic hypotheses

I. Describe the natural rate hypothesis. (5 points)

Answer: The natural rate hypothesis supposes that there is a natural rate of growth for certain real variables in the economy. Over time, the economy will automatically adjust to return these real variables to their natural levels.

2 points for the first sentence; 3 points for the second sentence.

II. Describe the theory of adaptive expectations and the theory of rational expectations, and explain how they differ. (3 points)

Answer: According to the theory of adaptive expectations, people adapt their expectations of inflation by looking at the recent past. According to the theory of rational expectations, people make their decisions based on information they gather about policies. The difference is whether people are looking to the past or to the future.

1 point for each sentence.

C. Fiscal policy, like monetary policy, relies on expectations. Describe the expectations that would render a tax cut ineffective. (2 points)

Answer: A tax cut is intended to get households and firms to spend more money. But if people believe that a tax cut is temporary, they'll save the money instead of spending it.

1 point for each sentence.

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D. Supply-side economics

I. What are the basic assumptions underlying supply-side economics? (2 points)

Answer: According to supply-side economics, production drives the economy. Economic growth is driven by making it easier for firms to increase production.

1 point for each sentence.

II. What policies do supply-side economists support? (2 points)

Answer:
1. Decreasing taxes and regulations on firms.
2. Decreasing the bargaining power of unions.
3. Decreasing the minimum wage.

1 point for any of the three answers — up to 2 points.

III. Explain the "trickle-down" theory. (3 points)

Answer: The trickle-down theory is based on the supply-side idea that if the government engages in policies that support business growth, employment and output will increase. This will lead to economic growth. Therefore, a tax cut for businesses will trickle down to unemployed workers in the form of new job opportunities.

1 point for each sentence.

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